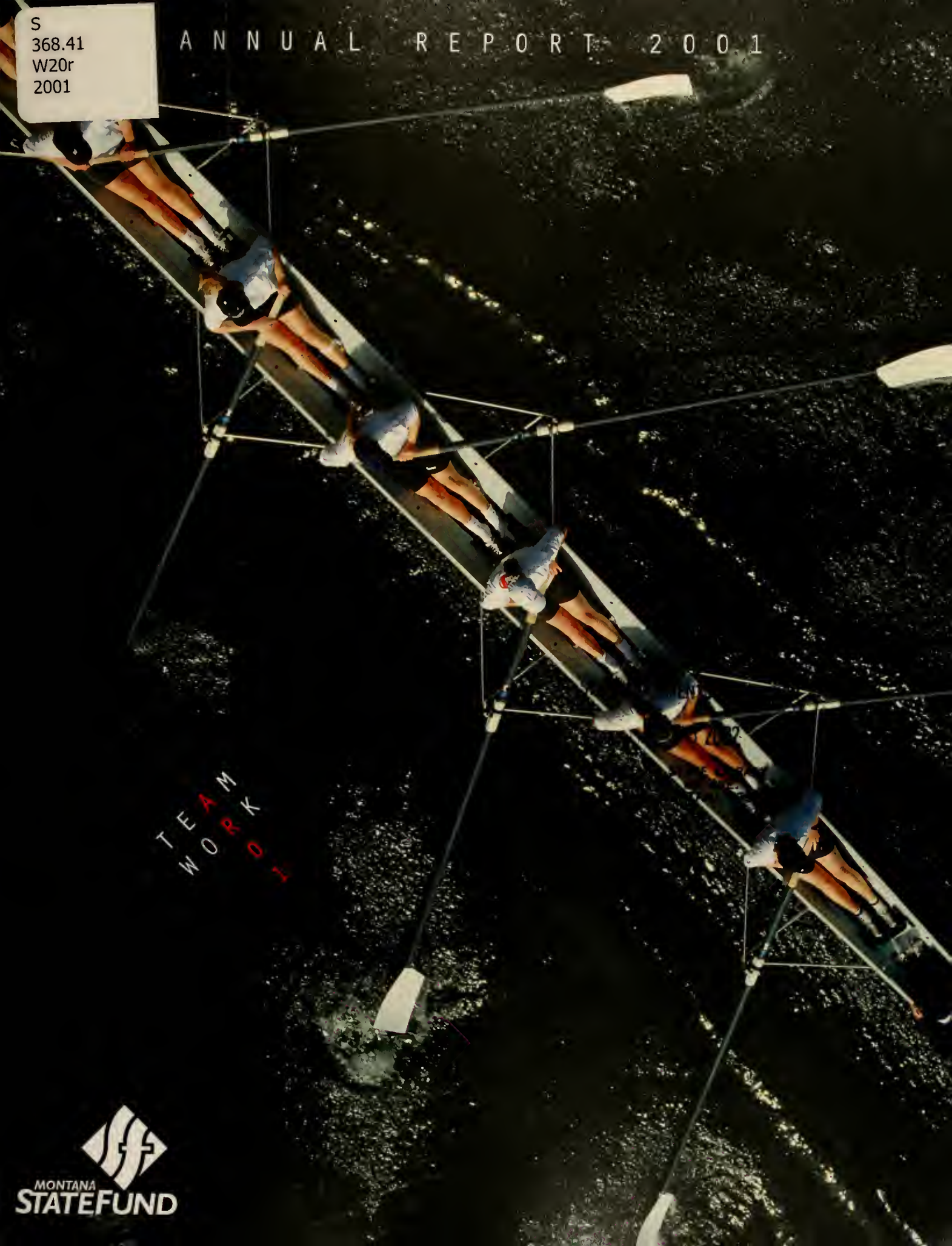
S
368.41
W20r
2001

ANNUAL REPORT 2001



MONTANA STATEFUND

MONTANA STATE LIBRARY
3 0864 0015 3443 0

TEAM WORK 01

MONTANA'S INSURANCE CARRIER OF CHOICE
AND INDUSTRY LEADER IN SERVICE.

Contents

01 Letter From the Chairman of the Board 02-05 Letter from the President: 2001- The Year in Review
13 2001 Key Financial Highlights | Montana State Fund Facts 14-21 Financials 22-23 Actuarial Letters
24 Report of Management back inside cover Board of Directors / Executive Staff

A MESSAGE FROM THE CHAIRMAN

The Montana State Fund (MSF) operates in a very dynamic and competitive environment. Our success in the past and our continued progress in the future are dependent upon our ability to anticipate and respond rapidly to service expectations and industry change. We have weathered the forces of change by relying on four basic principles as our foundation. They are:

STRENGTH-MSF now maintains a strong financial position to ensure continued long-term stability and financial solvency based on actuarial sound rates and reserves.

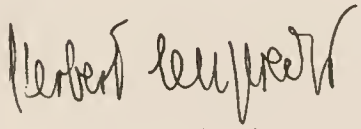
COMPETITION-MSF furnishes and markets high-quality insurance services and products at appropriate and competitive prices. By doing so, the premiums charged are more competitive for all Montana businesses, since we provide an option for any employer to purchase their mandatory workers' compensation coverage.

COMMITMENT-MSF operates in a customer-focused, team-oriented, high-performance culture that challenges and empowers our employees to deliver the highest quality insurance products to Montana businesses at the lowest possible cost consistent with sound insurance principles.

SERVICE-MSF provides coverage to nearly 24,000 businesses of all sizes. Our team-based account structures create customer loyalty by providing superior service to our policyholders and injured employees. By working with independent agents, we maintain a partnership with stakeholders in the true spirit of cooperation.

Last year the Board of Directors approved a fundamental redesign of the internal structure of the organization. The results of this redesign have been dramatic, and have increased both our performance and our efficiency. We have already seen these efforts bear fruit, and anticipate that this new structure will serve us well into the future.
The accomplishments made in the past year have also put us in an excellent position to pursue our goals of reducing workplace injuries, help injured employees get healthy and back to work sooner, and provide superior service to our customers. The Montana State Fund has led the way in providing workers' compensation insurance coverage to Montana businesses since 1915. Throughout the years, we have met the ever-changing needs of our customers, and we will continue to do so.

On behalf of the Board of Directors, I would like to thank our employees, our agents, and, most important, our policyholders for making 2001 another successful year for the Montana State Fund. I would also be remiss if I did not take this opportunity to thank all the members of the Board for their commitment of time and energy on behalf of the people of Montana. I appreciate your guidance, understanding and support, and admire you for your dedication and professionalism. The Board and staff of the Montana State Fund comprise a great team, and it's a pleasure to be able to serve with all of you.



Herbert Leuprecht, Chairman

Focusing an organization's energies towards a common purpose can have powerful results. This past year, we took dramatic steps in re-engineering our structure to better serve Montanans. As a result, Montana State Fund (MSF) has solidified our position in the marketplace as Montana's insurance carrier of choice and industry leader in customer service.

A Solid Financial Base in a changing Economic Climate

We witnessed a dramatic shift in the national business climate this past year. Investment markets continued their downward trend that began in 2000. Nationally, many companies found themselves in a retrenching mode, cutting back on both expenses and earning projections. There has been a "hardening" of the insurance market as the industry copes with decreased revenues, declining investment income and even stiffer competition. I am proud to report that through it all, MSF has been able to adapt and prosper. FY01 was another strong year for our organization. Net earned premium for this period grew by 5%, exceeding $74.5 million. Our net investment income also showed an increase by topping $31.5 million for the year. Given the turmoil of the financial markets, this was an exceptional result. We also were able to strengthen our policyholder surplus by $12 million to $150.9 million. Our loss reserves increased $11 million to nearly $326 million. Our reserves are undiscounted and stated at an amount slightly above the independent actuary's best estimate as a precautionary move against potential adverse development in our losses. Our strong surplus, along with our level of loss reserves, protects injured employees and other customers against the unknown events (including court cases), which may impact losses in any given accident year. MSF has a fiduciary responsibility to all who receive benefits to make certain that we retain adequate reserves to deal with any future contingencies. While balance sheets refer to this as a surplus, we view it as an obligation to all of those who have put their trust in our company. Our goal is to continue to slowly strengthen the reserves to surplus, allowing us to continue to operate as a strong and long-term viable insurance carrier, committed to the businesses in Montana.

For the third consecutive year, we were able to pay a dividend to our eligible policyholders with superior safety records. For FY01, 56.3% of our policyholders qualified. Cumulatively, over the past three years, $24 million has been given back to Montana businesses in dividends and returned premiums. While we cannot guarantee dividends into the future, I believe that continued strong performance and actuarial projections bode well in this regard.

In FY01, our Board voted to adopt the NCCI filed loss costs for MSF classification codes, allowing for a small number of exceptions for unique classifications. This policy brings us closer in line with private carriers. In addition, they approved a three-tiered rate structure with loss cost multipliers for each tier. This will help us to remain competitive in the marketplace, while still being able to provide coverage for any Montana employer at the most cost-effective and appropriate price.

Our reserve to surplus ratio (after dividend) was a solid 2.16, while the premium to surplus ratio came in at 0.49. By virtually every measure, this past year Montana State Fund maintained its history of solid financial performance.

Experience has taught us that when the economy is strong, claim frequency tends to decrease. As the economy weakens there is a correlating increase in frequency of lost time claims. Given the economic climate in the country today, this is something that we intend to watch very carefully. As the market

for workers' compensation insurance continues to harden, we will be doing all within our power to ensure that our products and services will be available at competitive and realistic price levels.

The Essence of Cooperation and Teamwork

Montana State Fund has taken some significant steps to be able to serve our customers in the most responsive, timely, courteous and professional manner possible. We recognized that if we were going to effectively serve our clients, we needed to re-engineer our organization to meet their needs.

Our move to multi-functional teams ensures that both policyholders and injured employees are serviced in a professional, courteous, empathetic and expeditious manner. Each team possesses the knowledge and skills needed to handle virtually any situation, resulting in quicker response to any inquiry. They are empowered and each team member is in effect a "business owner." Customer feedback has been excellent.

Our redesign also allowed us to improve our efforts in two critical areas: safety and medical case management. We've put an increased emphasis on safety training and prevention of accidents before they occur.

The Board has authorized us to implement a "gain sharing" program for all MSF employees. I believe that this is an important step and will be a key component to the continued success of our redesign efforts. It is a form of incentive compensation that rewards employees for exceptional results by having them share in the additional gain that they help create. Gain sharing also helps create an atmosphere of "business owners" and co-responsible employees, giving all MSF employees a stake in the company's continued success. This program will help us to improve our functions in a number of areas.

Our partnership relationship with independent insurance agents continues to grow. This past year, 48% of policies written came through these producers. We believe that local insurance producers serve an important segment of the market, provide a clear value-added service and we look forward to strengthening our association with them in the future.

Legislative Initiatives

One of the main themes of the 2001 legislative session was economic development. There seems to be an increasing awareness and agreement among our leaders that we need a concerted effort to improve our state's economic standing. Job and wage growth will only come about through the development of long-term strategies and improvements in a business climate that helps Montana capitalize on the talents within our workforce and the attractiveness of our communities. Legislation enacted during the past session has laid a new foundation, but there is much to do. I believe that it is now widely recognized that a stable and competitive workers' compensation system plays an important role in the Montana economic environment. To that end, we saw fourteen bills pass through the process that dealt with a variety of worker compensation related issues. I believe that two enacted pieces of legislation deserve special mention. Senate Bill 323 revised the exclusive remedy section of the Workers' Compensation Act. This bill overrules the Sherner v. Conoco case decided by the Montana Supreme Court in February 2000. In essence, the legislation requires an intentional and deliberate act of an employer for that employer to be liable outside the workers' compensation system. It restored the scope of exclusive remedy to its prior status before the Supreme Court decision. Senate Bill 145 was introduced at the request of Montana State Fund to improve functions and assist MSF in operating more like a

private insurance company. It gave us the ability, with Board approval, to expand our offerings to other workers' compensation related coverage. It also allows us to spend funds for scholarship, educational or charitable purposes, allowing MSF to act more like the good corporate citizens that we need to be. We appreciate the legislature's confidence and trust in our abilities, and look forward to continuing to partner with both the legislative and executive branches of government to improve the opportunities for all Montana businesses.

An Emphasis on Safety in the Workplace

While we've seen a downward trend in the frequency of claims over the past decade, medical and indemnity claim costs continue to rise. We know that claim frequency tends to go down when the economy is good. We also believe that improvements have been made in the safety "environment" of many workplaces. However, costs for medical care continue to rise, sometimes driven by advancements in medical technology and procedures. These advancements can help speed the recovery of injured employees, allowing them to get back to work sooner and continue to lead active and productive lives. This is good, but the downside is that claim costs will probably maintain their upward trend. In the early 90s we realized some significant savings through the institution of managed care practices for medical claims. Those savings have been factored into the marketplace, and we are now seeing a natural inflationary rise in costs. We are committed to do all within our power to provide the highest quality health care for injured employees. It should be the goal of any organization to find ways to return employees to work as quickly as possible. An employee who returns to work is part of a team, has social interaction, and has higher self-esteem. They are in an environment where they are once again contributing to others. As part of our corporate redesign, we doubled the number of medical case managers. Our case managers work hand in hand with health care professionals to design courses of treatment that will help injured employees get back on the job in the most efficient and cost-effective way possible. Early return to work programs makes sense. They help to minimize cost, but more importantly, they contribute to the well being of the employee, the company, and society.

We also took significant steps in strengthening our safety management programs. Our safety management consultant staff doubled in size, and traveled throughout Montana to educate employers and employees alike about the importance of workplace safety. Our philosophy is simple and succinct: Prevention is key. Safety is priceless. And knowledge is power.

That's why we visited over 1,500 policyholders in the past year. We provided them with the onsite, personalized safety inspections and customized training they need to keep their employees safe and healthy. We instructed them on how to conduct safety meetings, how to write a safety program and how to get their employees committed to workplace safety. We also held 16 safety seminars around the state that were free of charge to any employer. Our investment and commitment to safety is steadfast. MSF is putting the work in on the front end so the result for all can be a safer workplace environment.

Vision

The Montana State Fund plays a unique and important role in Montana. As a public entity, we acknowledge the obligation we have to the 900,000 citizens of our state. To that end, the MSF management and staff are dedicating a significant amount of resources towards increasing the effectiveness of all our programs. Simply stated, the vision of our organization is:

Montana State Fund is committed to the health and economic prosperity of Montana through superior service, leadership and caring individuals, working in an environment of teamwork, creativity and trust.

The true measure of who we are goes beyond our fiduciary responsibilities. We are Montanans, and recognize how fortunate we are to call this place our home. Our employees are active and involved, giving freely of their time and resources to improve our communities. As we move forward, this vision will be our guide.

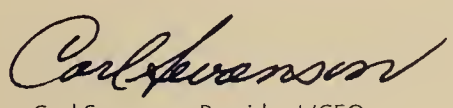
The Challenge of the New Reality

It's amazing how rapidly our world can change. The shock and disbelief that we all experienced from the events of September 11th has been transformed into a national resolve to prevail over terrorism. While we may never comprehend the reasons for why these attacks on innocent citizens occurred, we do know that our world has been changed forever. The experts and pundits tell us that 9/11 was a watershed event and we are still trying to come to grips in understanding how all of this impacts our lives. With troops currently engaged in combat overseas and increased security at home, we are facing challenges that none of us contemplated a few months ago.

This is also an unprecedented time for the insurance industry. It is still too early to identify with precision what the ultimate impacts will be, but the losses faced by a number of industry stalwarts are significant. Overall, I am confident that the property and casualty insurance industry has the financial capacity to meet their obligations. However, we can anticipate significant increases in reinsurance costs, reduced reinsurance capacity and continued market price firming. Carriers rely on the reinsurance market for coverage when faced with extraordinary claims. We've already begun to see reluctance on the part of some reinsurance providers to assume some potential risks. Fortunately, MSF has adequate reinsurance agreements in place. While we believe that markets will settle down in the future, we know that this is an area that we need to keep a close watch on.

Furthermore, the economic downturn that began in March 2000 has also begun to impact rates. For the near term, we know that we will see some retrenching occurring in the marketplace. However, we are in a strong position to face whatever uncertainties the future may hold. The dedication and hard work of our employees have made us the insurance carrier of choice in Montana. A fundamental component of our new structure is our commitment to be a key contributor to the health and well being of our fellow citizens. We fill a critical role in the economy of our state that will take on increasing significance.

I am grateful for the guidance and support given to us by our dedicated Board of Directors. Working together with an outstanding staff, Montana State Fund has made significant strides. We know that our work is far from done, and that there will be many challenges to face in the years to come. Nonetheless, as we move forward, I am certain that the Montana State Fund will continue to be an industry leader, justifying the trust and faith our customers have placed in us.



Carl Swanson, President/CEO

They're my safety partner.

Tiffani Juhnke | Talgo LRC

"Montana State Fund is ready and waiting to help us. They send people out to see us at least once a month and they do training for free. They're my safety partner."

They actually come here to work with us.

Spencer Williams | West Paw

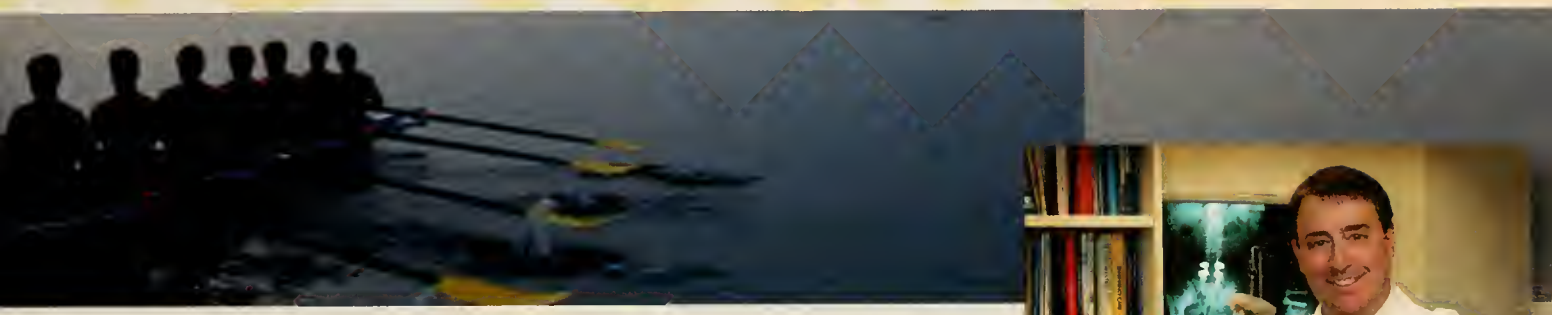
"I look at Montana State Fund as a partner because they actually come here to work with us rather than just giving us a set of demands that we have to fulfill. We're working together."

Montana State Fund is part of our team.

Terry Sprenger | Western Energy

"They sit down and talk with us about what can be done to make our work place as safe as possible. We explore different ways or better ways of getting the job done."

In June of 2000, the Board of Directors gave their approval to a process that has re-invented how the Montana State Fund functions as a business entity. All aspects of the organization were evaluated and a new structure was put in place on November 8, 2000. The cornerstone of our new organizational structure is based upon six multi-functional teams that serve a specific group of customers and their employees. Each team provides all account and claims management services for their assigned policies, and in doing so, are better able to focus on their customers' needs, wants, and expectations.



These changes have resulted in a renaissance of internal employees' accountability, ownership and sense of pride in the work they are doing on behalf of the injured workers, employers, medical providers, and other MSF stakeholders. The team structure has also allowed us to enhance our communications. We are getting to know each of our customers better through increased field presence and can provide improved attention to their needs. The upshot of these changes has resulted in a dramatic upgrade in the services that we provide. The increases we are experiencing in customer retention rates are proof that MSF has become more attuned and responsive to the people that we serve.

I get the answers I need from Montana State Fund.

Dr. Steven Rizzolo | Orthopedic Associates

"They work with my staff and me to make sure there are no delays in providing treatment."

Taking the step to redesign the floor layout and reconfigure the physical make up of our building set the stage for the service transformation that followed. And the process continues to evolve. Refinements in our processes and customer programs continue to be enhanced by the staff that is doing the front line work. They know what works, what doesn't, and what is needed to get the job done well. They are suggesting new procedures, challenging traditional thinking and creating enhancements each day that reflect the image our organization is now known for - the insurance company of choice and industry leader in service in Montana.

TEAMWORK AR01

Workplace injuries are costly to employees and employers alike. We recognize that there are substantial social and economic benefits to be derived from accident prevention. To that end, we doubled the number of our safety management consultants in fiscal year 2001. Our consultants made 1,507 safety visits at worksites throughout Montana. The results of these efforts are translated into a reduction in injuries and cost savings for the businesses that received focused service.

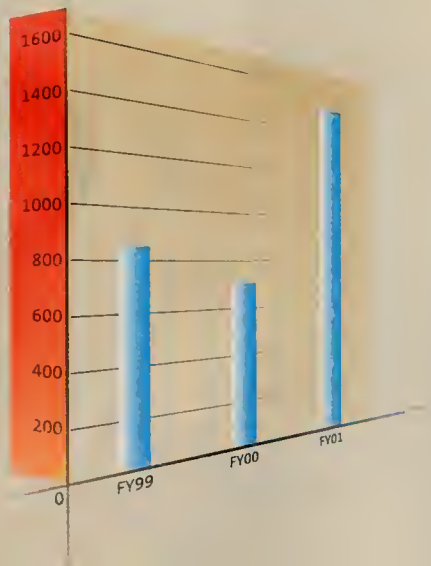
They're right beside us, helping us establish safety programs, working with our people.

Terry Sprenger | Western Energy
"The safety record is important to us and Montana State Fund. They're right beside us, helping us establish safety programs, working with our people. They've made our job much easier."

The biggest win is by the employees themselves.

Spencer Williams | West Paw
"Partnering with companies to reduce claims and improve safety is a win-win for both Montana State Fund and the employer. But the biggest win is by the employees themselves."

SAFETY MANAGEMENT VISITS



They've been very proactive.

Rene Leveaux | Agent
"Montana State Fund has been very hands on. They have loss control representatives living throughout the state. They've been very proactive in trying to help people before there is a loss or an accident."

They really do care about their customers.

Rene Leveaux | Agent

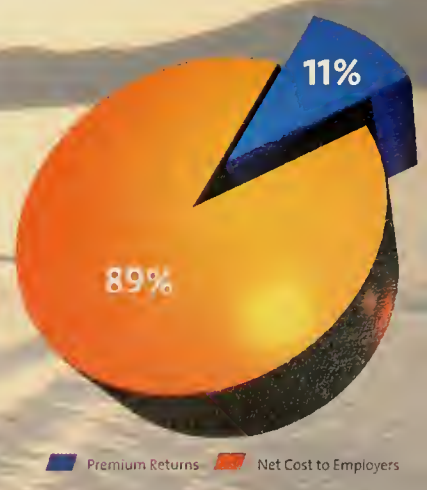
"The fact that Montana State Fund gives back $24 million in a three-year period of time tells me a lot about the company and the way the company is run. They really do care about their customers."

The existence of a financially viable Montana State Fund is critical to a healthy and competitive insurance market in Montana. By providing an option for any employer to purchase their mandatory workers' compensation coverage, the premiums charged to all Montana businesses remain more competitive. In addition, as a financially sound organization, we are able to return any surplus beyond what is needed for prudent business operations in the form of dividends to qualifying Montana employers. Cumulatively, for the past 3 years, we have been able to return $24 million back to businesses in our state. That money stays in our communities and rewards organizations that make workplace safety a priority. In short, the Montana State Fund is an investment that returns significant benefits to the people of Montana.

PERCENT OF GROSS EARNED PREMIUM RETURNED TO MSF CUSTOMERS

Returns Include Dividend and Loss Sensitive Plan Credits/Debits Valued as of 10/1/2001

Since 1999 when the MSF began issuing dividends to its policyholders, 11% of customers' up-front premium costs have been returned in the form of either dividends or loss sensitive plan returns. This is due, in no small part, to the significant emphasis placed on safety management programs at MSF. Although dividends cannot be guaranteed, we are in a strong financial position, which enhances the likelihood for continuance of the dividend program in the years to come.



TEAMWORK AR 01

At Montana State Fund, we have made a commitment to independent insurance agencies across Montana. These qualified professionals are in a unique position to serve their customers. Much of our growth over the past few years has been due to this mutually successful partnership. For fiscal year 2001, the growth in agency earned premium was 23.6%. The customer retention rate for the same year in this sector was an impressive 86.6%. As a result of our reorganization, we have focused on improving our field contact with agencies, especially in the safety management area. Teaming together, we are able to provide a level of service to our customers that was previously unavailable in many parts of our state.

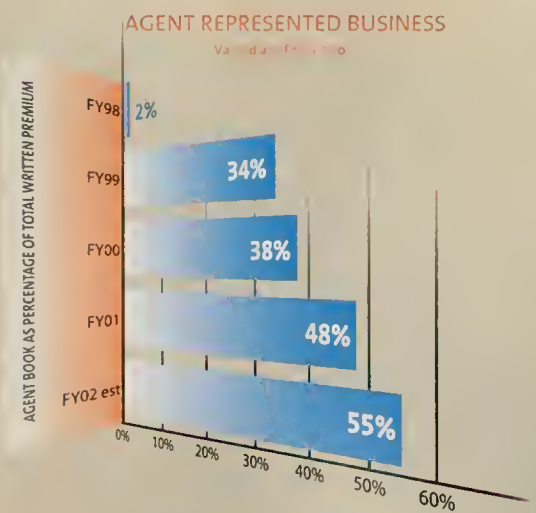
They care about Montana employers.

Rene Leveaux | Agent

"The people at Montana State Fund are very accommodating; they care about Montana employers. They're a Montana-based company and they're really familiar with the needs of Montana-based companies."

partnersh

The percentage of the MSF business represented by independent agents has increased dramatically since the pilot program was launched in 1998.



Insurance companies from outside the state might not have that same commitment.

Spencer Williams | West Paw

"We're a local company and Montana State Fund is a local insurance provider so we have a common interest in and commitment to our state. Insurance companies from outside Montana might not have that same commitment."

retentio

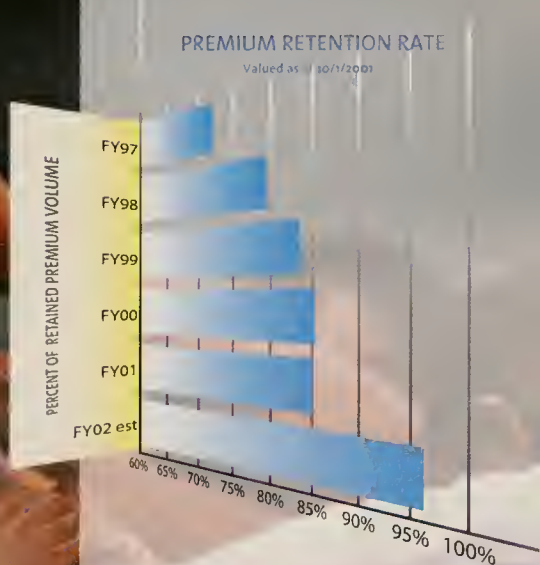
I would recommend Montana State Fund.

Ron Smith |
Injured Employee
"Based on my experiences, I would recommend Montana State Fund."

ip

Insurance is a highly competitive industry. Employers in Montana can choose from a number of carriers for their worker compensation insurance needs. That's why we are extremely gratified to have such a solid retention rate among our customers. In the soft market conditions of the late 1990s, MSF's retention of written premium was relatively low by industry standards. However, in the last few years, we've experienced a dramatic increase in the number of customers who continue to choose MSF as their insurance carrier of choice. With our improved emphasis on customer satisfaction and service, we anticipate that the retention of written premium in 2002 will exceed 95%. We appreciate the trust and confidence that our customers continue to place in us, and look forward to continuing to partner with them in the future.

In the soft market conditions of the late 1990s, MSF's retention of written premium was relatively low by industry standards. However, in the last few years as MSF has established itself as the industry leader in service and carrier of choice in Montana, retention has dramatically improved. Retention of written premium in 2002 is expected to exceed 95%.



Accurate, speedy and efficient data handling is a requirement for any organization to be successful in the 21st century. To that end, the Montana State Fund has made significant investments in our data-processing infrastructure to best serve our 24,000 customers. Our most recent acquisition of a 1.2 terabyte storage area network will give us the ability to maintain all our data in one location. This gives us a considerable advantage in processing efficiency and should take care of our storage requirements for the next 5 years. It also is an important step to ensure that all our vital data can be easily recoverable in a disaster or emergency situation. We have invested a considerable amount of time and resources to ensure that MSF can be back on line and available for our customers should the need arise. We've taken a proactive approach to our systems infrastructure in order to become more responsive to the needs of our clients and be able to deliver information to them on a real time basis. Looking into the future, we've developed an E-commerce strategic planning initiative that will guide our efforts in the years to come.

At the Montana State Fund we believe that data is an essential tool. Our investment in infrastructure, redundancy, recovery, and innovative software are not visible to the casual observer. However, they are critical components of our organization and will serve as a foundation for all our operations in the years ahead.

Montana State Fund offers me a lot of peace of mind.

Tiffani Juhnke | Talgo LRC

"Montana State Fund offers me a lot of peace of mind. I know if I have a question, even if it's something trivial, I can call up our safety manager and he'll answer it."

service innovation

Corporate Redesign Results

- Creation of multi-functional teams with focus on select groups of customers and their employees; teams focused on customers on geographic, premium size, agent-represented basis.
- Organizational structure is flattened to empower employees to make appropriate decisions.
- Management staff reduced from 42 to 24 FTEs.
- Total number of FTEs reduced by 6.5, but increased staffing in safety management, medical case management and quality control.

Transition to an Entrepreneurial Organization

- Aligning with NCCI to make it easier to compare MSF products to those offered by private carriers.
- Legislation enacted allowing for expanding coverage, as well as scholarships and charitable contributions.
- Forms, procedures and programs improved in key areas to enhance the ease of doing business with MSF.

Knowledge Management

- Nearing completion on data warehouse program to provide management reports and trending information to enhance business management capabilities and performance.
- Information Technology (IT) methodology implemented to allow for a comprehensive approach to internal and external IT needs.

Marketing and Sales Capabilities

- Independent Insurance Agent network expanded and strengthened to provide for greater reach and better customer service.
- Consumer advertising program launched statewide focusing on the importance of workplace safety.

AS OF JUNE 30, 2001

Earned premium	$74,510,374
Number of policies serviced	26,251
Total number of claims processed	10,969
Number of FTEs	225
Investment Income	$31,519,273
Net Income	$6,586,501
Reserve to Surplus ratio (after dividend)	2.16
Premium to Surplus ratio (after dividend)	0.49
Equity	$150,879,539
Total Fraud Savings since inception	$11,920,882

Ad Campaign Scores 2nd Best Nationwide

Montana State Fund's "Safety Pays" print campaign took a 2nd Place Award at the American Association of State Compensation Insurance Fund's 2001 Publications Contest. The AASCIF is an association of workers' compensation companies from 38 funds in the U.S. and Canada.

STATUTORY STATEMENTS OF ADMITTED ASSETS

YEARS ENDED JUNE 30,	(Audited) 2001	(Unaudited) 2000
INVESTMENTS		
Bonds	$421,916,311	$420,103,679
Equity Securities	23,703,663	–
Cash and Short–Term Investments	31,029,459	29,952,970
Other Investments – Collateral Securities on Loan	88,689,281	100,180,241
Total Investments and Cash	565,338,714	550,236,890
OTHER ADMITTED ASSETS		
Premium Receivables	18,563,698	14,553,298
Equipment (net)	944,602	863,270
Interest Receivable	7,163,948	6,988,996
Other Assets	1,462,176	491,179
Total Admitted Assets	$593,473,138	$573,133,633

STATUTORY STATEMENTS OF LIABILITIES AND SURPLUS

LIABILITIES		
Losses Incurred Reserves	$289,988,342	$280,085,092
Loss Adjustment Expense Reserves	35,911,658	34,814,908
Liability for Securities on Loan	88,689,281	100,180,241
Deferred Revenue	16,157,343	14,593,271
Other Liabilities	11,846,975	4,691,745
Total Liabilities	442,593,599	434,365,257
CONTINGENCIES AND SUBSEQUENT EVENTS		
SURPLUS		
Policyholders' Surplus	150,879,539	138,768,376
Total Liabilities and Surplus	$593,473,138	$573,133,633

STATUTORY STATEMENTS OF OPERATIONS AND CHANGES IN SURPLUS

YEARS ENDED JUNE 30,	(Audited) 2001	(Unaudited) 2000
Net Premium Earned	$74,510,374	$70,656,612
Losses Incurred	71,606,236	65,327,377
Loss Expenses Incurred	11,590,179	13,056,648
Underwriting Expenses Incurred	12,956,586	10,530,927
Net Underwriting Loss	$(21,642,627)	$(18,258,340)
Net Investment Income Earned	31,519,273	30,068,942
Net Realized Capital Gains (Losses)	2,123,631	340,119
Premium Balances Recovered (Charged Off)	(465,502)	146,661
Other Income	46,985	49,885
Net Income Before Dividends	11,581,760	12,347,267
Policyholder Dividends	(4,995,259)	(6,950,716)
Net Income After Dividends	6,586,501	5,396,551
Prior Year End Fund Equity	138,768,376	133,519,729
Net Unrealized Gains (Losses) on Equity Securities	(296,337)	
Change in Nonadmitted Assets	(903,501)	(109,622)
Aggregate Write In for Gains or (Losses) in Surplus	(40,527)	(38,282)
Transfer In from Old Fund	6,765,027	–
END OF PERIOD SURPLUS	$150,879,539	$138,768,376

STATUTORY STATEMENTS OF CASH FLOWS

YEARS ENDED JUNE 30,	(Audited) 2001	(Unaudited) 2000
CASH FLOWS FROM OPERATIONS		
Premiums Collected Net of Reinsurance	$ 69,776,324	$ 70,703,859
Loss and Loss Adjustment Expenses Paid	(72,196,414)	(66,156,656)
Underwriting Expenses Paid	(11,813,895)	(10,974,502)
Cash Used For Underwriting	(14,233,985)	(6,427,299)
Net Investment Income	31,612,594	30,320,026
Other Income (Expenses):		
Agents' Balances Charged Off	(465,502)	
Net Funds Held Under Reinsurance Treaties	(37,000)	
Net Amount Withheld or Retained for Account of Others	4,387,758	575,189
Miscellaneous Income	46,985	–
Total Other Income	3,932,241	575,189
Dividends to Policyholders	(4,995,259)	(6,950,716)
Net Cash From Operations	16,315,591	17,517,200
CASH FLOWS FROM INVESTMENTS		
Proceeds from Investments Sold, Matured or Repaid:		
Bonds	134,583,457	58,507,650
Change in Collateral Securities	11,490,960	(8,451,970)
Total Investment Proceeds	146,074,417	50,055,680
Cost of Investments Acquired (long–term only):		
Bonds	(134,605,307)	(57,695,144)
Stock	(24,000,000)	–
Other Investments	–	(924,921)
Cost of Investment Acquired	(158,605,307)	(58,620,065)
Net Cash Used For Investments	(12,530,890)	(8,564,385)
CASH FLOWS FROM FINANCING AND MISCELLANEOUS SOURCES		
Cash Provided:		
Changes in Surplus	8,443,590	3,730,495
Cash Applied:		
Transfers to Affiliates	(1,028,308)	(8,286,526)
Other Applications	(10,123,494)	(340,095)
Net Cash Used for Financing and Miscellaneous Sources	(2,708,212)	(4,896,126)
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,076,489	4,056,689
CASH AND CASH EQUIVALENTS – BEGINNING OF YEAR	29,952,970	25,896,281
CASH AND CASH EQUIVALENTS – END OF YEAR	$ 31,029,459	$ 29,952,970

NOTES TO STATUTORY FINANCIAL STATEMENTS
JUNE 30, 2001 and 2000

NOTE A – ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. Organization

The Montana State Fund (MSF) is a nonprofit, independent public corporation established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is a component unit of the State of Montana. MSF is attached to the State of Montana, Department of Administration for administrative purposes only. MSF governs, operates and completes its financial reporting as an insurance company domiciled in the State of Montana.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. State law requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. State law also requires MSF to establish a minimum surplus balance of 25% of annual premium revenue.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as the New Fund (MSF). This report reflects only the operations of the Montana State Fund (New Fund only). MSF administers and manages the remaining claims of the Old Fund for an administrative fee.

State law requires that any excess surplus in the Old Fund above an amount deemed as adequately funded by state law up to $63.8 million be transferred to the Montana State Fund. This is the first transfer received in accordance with state law.

2. Basis of Presentation

The financial statements of the Montana State Fund are presented on the basis of accounting practices prescribed or permitted by the Montana Insurance Department. The Montana Insurance Department recognizes only statutory accounting practices prescribed or permitted by the State of Montana for determining and reporting the financial condition and results of operations of an insurance company, and for determining its solvency under the Montana Insurance Law.

The National Association of Insurance Commissioners' (the NAIC) *Accounting Practices and Procedures Manual* (APPM) version effective January 1, 2001 ("NAIC SAP") has been adopted as a component of prescribed or permitted practices by the State of Montana. The APPM includes the Statements of Statutory Accounting Principles (SSAPs), the preamble and the appendices. The APPM is not intended to preempt states' legislative and regulatory authority. It is intended to establish a comprehensive basis of accounting recognized and adhered to in absence of, conflict with, or silence of, state statutes and/or regulators.

The Montana Code Annotated references conformity with the Accounting Practices and Procedures Manual within section 33–2–701(1) and therefore concludes that no legislation is necessary to adopt its use.

The State of Montana has adopted certain prescribed accounting practices that differ from those found in NAIC SAP.

There is no difference in MSF's net income, capital and surplus between NAIC SAP and the practices prescribed and permitted by the State of Montana.

3. Significant Accounting Policies

Cash and Cash Equivalents – Cash constitutes a medium of exchange that a bank or other similar financial institution will accept for deposit and allow an immediate credit to the depositor's account. Also classified as cash are savings accounts, certificates of deposits with maturity dates of one year or less, and cash equivalents. Cash equivalents are: investments with original maturities of three months or less; are readily convertible to known amounts of cash; and, present insignificant risk of change in value due to changes in interest rates. The Montana State Treasury holds MSF's cash and cash equivalent balances.

Short–term Investments – Short–term Investments are those investments with remaining maturities of one year or less at the time of acquisition, excluding those investments classified as cash equivalents. Short–term investments include but are not limited to, bonds, commercial paper, money market instruments, repurchase agreements, and collateral and mortgage loans that meet the above criteria. Short–term investments shall not include certificates of deposit.

Premium Receivable – SSAP 6 in the APPM requires premium receivable balances with an amount due over 90 days to be nonadmitted assets and charged to surplus. In addition, the new SSAP guidance requires that the remaining admitted accounts receivable asset be reviewed for impairment. If, in accordance with SSAP 5, it is probable the balance is not collectible, the uncollectible receivable shall be written off and charged to income in the period the determination is made.

Risks and Uncertainties – SSAP 1 requires disclosures of risks and uncertainties existing as of the date of the financial statements, as follows:

Use of Estimates – MSF is required to make estimates and assumptions when preparing its financial statements and accompanying notes in conformity with statutory accounting principles. Actual results could differ from those estimates.

Loss and LAE Reserves – Loss and loss adjustment reserves (estimated claims payable) are established to provide for the estimated ultimate settlement cost of all claims incurred. Loss reserves are based on individual claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported claims, as determined by management in conjunction with an independent consulting actuary. Management believes that the reserves for unpaid losses and loss adjustment expenses are adequate; however, there can be no assurance that the ultimate settlement of losses may not vary materially from the estimate recorded. Since liabilities are based on estimates, the ultimate liability may be in excess of, or less than, the amounts provided. Adjustment to these estimates of reserves will be reflected in the Statutory Statement of Operations in future years.

Uncertainty Due to Litigation – In the ordinary course of business, MSF is a defendant in various litigation matters. Although there can be no assurances, as of June 30, 2001 and 2000, in the opinion of MSF's management based on information currently available, the ultimate resolution of these legal proceedings would not be likely to have a material adverse effect on its statutory results of operations, financial condition or liquidity.

Vulnerability Due to Certain Concentrations – MSF used approximately 48 agencies located throughout Montana to write workers compensation policies with gross written premiums of $37,909,818 for the year ended June 30, 2001. MSF conducts its business within the State of Montana for the most part and is susceptible to risk based on the economy of the geographic territory it serves.

Administrative Cost Allocation – State law requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1.25 million for fiscal year 2001 and 2000, respectively. The Montana State Fund allocated $1.25 million in administration costs to the Old Fund in fiscal years 2001 and 2000, respectively. The Old Fund has a $771,804 contingent obligation to the Montana State Fund in unrecovered administrative costs incurred in fiscal years prior to 2000–2001, consequently, it is not recorded on these financial statements. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1.25 million.

Long–Term Securities – Long–term securities consist of equity securities and bonds. Long–term securities are held by the Montana Board of Investments (BOI) and State Street Bank is the custodial bank for the BOI. Equity securities are valued at fair market value. Bonds are rated and valued in accordance with the Securities Valuation Office (SVO) rating guidelines. Bonds with a SVO rating of 1 and 2 are valued at amortized cost. Bonds with a SVO rating of 3 or higher are valued at the lower of cost or market. Bond amortization is calculated using the straight–line method. MSF has no derivative investments.

Electronic Computer Equipment and Software – Electronic computer equipment is recorded at cost and depreciated on a straight–line basis over an estimated useful life of three years. Equipment is capitalized if the actual or estimated historical cost exceeds $5,000. Software is amortized on a straight–line basis using a three–year life for operating software and a five year life for application software.

Furniture, Equipment and Leasehold Improvements – Furniture and equipment are recorded at cost and depreciated on a straight–line basis using estimated useful lives, which range from 5 to 10 years. There are no leasehold improvements to property owned by the State of Montana and used by MSF requiring amortization. SSAP 16 requires that furniture, fixtures, equipment and leasehold/property improvements be capitalized, depreciated and nonadmitted.

Losses Incurred and Loss Adjustment Expense Estimates – Tillinghast–Towers Perrin, an actuarial firm independent from MSF, prepared an actuarial study of estimated liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported for MSF as of June 30, 2001 and June 30, 2000. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. As of June 30, 2001 and 2000, $325,900,000 and $314,900,000, respectively, of unpaid claims and claim adjustment expenses are presented at face value net of estimated reinsurance recoverable.

Deferred Revenue – Deferred revenue reflects amounts billed or received in advance, but not yet earned for policies effective July 1, 2001 and 2000.

Other Liabilities consist of:

- Security Deposits – Security deposits are monies held on behalf of certain insured's due to their loss ratios; in addition, funds withheld per the reinsurance contract are also included in this account.

- Accounts Payable – Accounts payable includes liabilities incurred on behalf of claimants, refunds due to policyholders and amounts due to vendors.

- Compensated Absences – Employees at MSF accumulate both annual leave and sick leave. MSF pays employees for 100% of unused annual leave and 25% of unused sick leave upon termination. MSF pays 100% of unused compensatory leave credits upon termination to nonexempt employees. MSF absorbs expenditures for termination pay in its annual operational costs. MSF had a total leave accrued liability of $1,161,284 and $927,052 at June 30, 2001 and 2000, respectively.

Income Taxes Payable – MSF is a component unit of the State of Montana and is not subject to Federal or State income tax.

Premium Revenue – Premiums are recognized as revenue on a pro–rata basis over the policy period, beginning on the effective date of the policy. Advance premiums are deferred until the effective date of the policy at which time they are recognized as revenue on a pro–rata basis over the term of the policy. MSF's Board of Directors approves premium rates annually. Revenue from premiums is recognized over the term of the policy year. Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and MSF has credited all earned premiums.

NOTE B – INVESTMENTS

The investments of MSF as of June 30, 2001 and 2000 are as follows:

June 30, 2001	Carrying Value	Unrealized Gains	Unrealized Loss	Market Value
US Treasury Securities	$ 65,919,685	$ 4,224,915	$ 67,988	$ 70,076,612
US Government Agencies and US Government Guaranteed Securities	125,728,809	2,840,225	1,331,045	127,237,991
Corporate Securities				
Asset Backed	20,223,021	324,388		20,547,884
Other Corporate Securities	203,331,227*	5,190,512	1,923,415	207,606,526
Other Securities	6,713,569*	47,634	430,184	6,587,390
Total Bonds	$421,916,311	$12,627,674	$ 3,752,632	$432,056,403
Common Stock Index Fund	$ 23,703,663	$ –	$ 296,337	$ 23,703,663
Cash in Treasury	2,411,937			2,411,937
STIP	28,617,522			28,617,522
Total Cash and Short Term Investments	$ 31,029,459	$ –	$ –	$ 31,029,459

June 30, 2000	Carrying Value	Unrealized Gains	Unrealized Loss	Market Value
US Treasury Securities	$ 84,160,568	$ 2,000,562	$ 273,450	$ 85,887,680
US Government Agencies and US Government Guaranteed Securities	83,066,242	648,088	3,308,876	80,405,451
Corporate Securities				
Asset Backed	41,384,510	691,161	332,950	41,051,560
Other Corporate Securities	192,547,019*		7,615,252	186,822,928
Other Securities	18,945,340		680,660	18,264,680
Total Bonds	$420,103,679	$ 3,339,811	$12,211,188	$412,432,299
Cash in Treasury	2,435,818			2,435,818
STIP	27,517,152			27,517,152
Total Cash and Short Term Investments	$ 29,952,970	$ –	$ –	$ 29,952,970

*These categories include securities which are rated class 3–6 by the SVO and are carried at the lower of cost or market. All other bonds are rate class 1 or 2 and are valued at amortized cost.

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2001 and June 30, 2000, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligatio with or without call or prepayment penalties.

June 30, 2001	Carrying Value	Market Value
Due one year or less (includes STIP)	$ 33,067,522	$ 33,067,522
Due after one year through five years	164,828,051	170,332,344
Due after five years through ten years	125,897,300	129,727,325
Due after ten years	126,740,960	127,546,734
Totals	$450,533,833	$460,673,925

June 30, 2000	Carrying Value	Market Value
Due one year or less (includes STIP)	$ 39,179,405	$ 39,046,002
Due after one year through five years	240,327,623	237,382,893
Due after five years through ten years	111,800,321	109,761,036
Due after ten years	56,313,482	53,759,520
Totals	$447,620,831	$439,949,451

During fiscal year ending June 30, 2001 MSF realized gross gains from sales of securities of $2,583,238 and gross realized losses of $459,607. During fiscal year ending June 30, 2000, MSF realized gross gains from sales of securities of $639,917 and gross realized losses of $299,798.

NOTE C – CASH COLLATERAL AND LIABILITY FOR SECURITIES ON LOAN

Under the provisions of state statutes, the Montana Board of Investments (BOI) has, by a Securities Lending Authorization Agreement, authorized the custodial bank to lend BOI's securities to broker–dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. State Street Bank was appointed the BOI's custodial bank on December 1, 1993. During the period the securities are on loan, BOI receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral equal to not less than 100% of the market value of the loaned security. BOI retains all rights of ownership during the loan period.

BOI did not impose any restrictions during fiscal years 2001 and 2000 on the amount of the loans that State Street made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2001 and 2000. There were no losses during fiscal years 2001 and 2000 resulting from default of the borrowers or State Street.

During fiscal years 2001 and 2000, BOI and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which BOI could not determine. On June 30, 2001 and June 30, 2000, BOI had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the total collateral held for fiscal years 2001 and 2000:

	Fiscal Year 2001	Fiscal Year 2000
Securities on Loan – Book Value	$80,458,558	$94,981,807
Securities on Loan – Market Value	$85,193,815	$96,497,807
Total Collateral Held	$88,689,281	$100,180,241

NOTE D – SHORT–TERM INVESTMENTS

MSF participates in the Short–Term Investment Pool (STIP) maintained by BOI. STIP balances are highly liquid investments. There are no legal risks that BOI is aware of regarding STIP investments. The market value of STIP approximates cost.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. BOI's policy requires that STIP investments have the highest rating in the short–term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The four NRSRO's include Standard and Poor's; Moody's Investors Service; Fitch, IBCA, Duff and Phelps; and Thomson Bank Watch.

NOTE E – ELECTRONIC COMPUTER EQUIPMENT AND SOFTWARE

Electronic computer equipment is recorded at cost and depreciated on a straight–line basis over an estimated useful life of three years. Equipment is capitalized if the actual or estimated historical cost exceeds $5,000. Software is amortized on a straight–line basis using a three year life for operating software and a five year life for application software.

	Equipment and Operating Software	Application Software	Total
Balances June 30, 2001			
Assets	1,896,003	7,994,860	9,890,863
Accumulated Depreciation	951,401	1,979,147	2,930,548
Net Assets Nonadmitted	–0–	6,015,713	6,015,713
Net Assets Admitted	944,602	–0–	944,602
Depreciation Expense	239,020	1,056,093	1,295,113

Furniture and Equipment – Furniture and equipment are recorded at cost and depreciated on a straight–line basis using estimated useful lives, which range from 5 to 10 years.

SSAP 16 requires that furniture, fixtures and equipment be capitalized, depreciated and nonadmitted.

	Furniture and Equipment
Balances June 30, 2001	
Assets	869,418
Accumulated Depreciation	505,572
Net Assets Nonadmitted	363,846
Net Assets Admitted	–0–
Depreciation Expense	54,530

Building – The 1981 Legislature appropriated funds for the construction of the Workers' Compensation building. As of July 1, 1990, MSF transferred the value of the building from its records to the Department of Administration, which owns most other state buildings. Under the agreement, MSF pays all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance.

Nonadmitted Assets – Certain assets designated as "nonadmitted" are excluded from the Statutory Statement of Admitted Assets. Liabilities and Surplus and the change in such assets are charged directly to unassigned surplus.

NOTE F – ESTIMATED CLAIMS PAYABLE

Loss and loss adjustment reserves (estimated claims payable) are established to provide for the estimated ultimate settlement cost of all claims incurred. Loss reserves are based on individual claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported claims, as determined by management in conjunction with an independent consulting actuary. Management believes that the reserves for unpaid losses and loss adjustment expenses are adequate; however, there can be no assurance that the ultimate settlement of losses may not vary materially from the estimate recorded. Since liabilities are based on estimates, the ultimate liability may be in excess of, or less than, the amounts provided. Adjustment to these estimates of reserves will be reflected in the Statutory Statement of Operations in future years.

The following analysis provides a reconciliation of the activity in the reserve for losses and loss expenses.

Year ended June 30, 2001	Losses Incurred Reserves	Loss Adjustment Reserves	2001 Total
At beginning of year:			
Net reserves for losses and loss expenses	$280,085,092	$34,814,908	$314,900,000
Acquisitions			
Losses and loss expenses incurred	71,606,236	11,590,179	83,196,415
Losses and loss expenses paid	(61,702,986)	(10,493,429)	(72,196,415)
At end of year:			
Net reserve for losses and loss expenses	$289,988,342	$35,911,658	$325,900,000

Year ended June 30, 2000	Losses Incurred Reserves	Loss Adjustment Reserves	2000 Total
At beginning of year:			
Net reserves for losses and loss expenses	$268,111,138	$35,388,892	$303,500,030
Acquisitions			
Losses and loss expenses incurred	65,327,377	13,056,648	78,384,025
Losses and loss expenses paid	(53,353,423)	(13,630,632)	(66,984,055)
At end of year:			
Net reserve for losses and loss expenses	$280,085,092	$34,814,908	$314,900,000

NOTE G – RETIREMENT PLANS, DEFERRED COMPENSATION AND POSTRETIREMENT PLANS

MSF and its employees contribute to the Public Employees Retirement System (PERS), a mandatory multiple–employer, cost–sharing, defined benefit pension plan administered by the State of Montana Public Employees Retirement Division (PERD). The PERS offers retirement, disability and death benefits to plan members and their beneficiaries. MSF and its employees each were required to contribute 6.9% of annual compensation for fiscal years 2001 and 2000. This amounted to a combined contribution of approximately $1,166,000 and $1,096,000, respectively. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2001 or 2000.

NOTE H – CAPITAL AND SURPLUS AND POLICYHOLDERS' DIVIDEND RESTRICTIONS

Dividend Paid to Policyholders

During fiscal year 2001 and 2000, the MSF's Board of Directors authorized a dividend to be paid to policyholders of record during fiscal year 1999 and 1998, respectively.

Payment of the dividend totaling $4,995,259 was accomplished during May 2001 and the payment totaling $6,950,716 was accomplished during May 2000.

NOTE I – REINSURANCE ASSUMED AND CEDED

For the fiscal years ended June 30, 2001 and 2000, MSF ceded reinsurance to other insurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against loss occurrences over stipulated amounts and an aggregate stop loss contract covering all losses during fiscal year 2001. These arrangements provide protection up to a total of $94.4 million coverage for fiscal year 2001. The aggregate stop loss contract covering fiscal year 2000 was commuted. During fiscal year 2001 MSF retained the first $3,000,000 with a $500,000 aggregate annual deductible for the first layer of reinsurance coverage. During fiscal year 2000 MSF retained the first $1,500,000 with a $750,000 in aggregate annual deductible for the first layer. Individual per person coverage is provided up to $5 million per any one individual loss. In the event reinsurers are unable to meet their obligations, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

MSF purchased reinsurance coverage for Employers' Liability insurance offered to policyholders during fiscal years 2001 and 2000. MSF retained the first $200,000 in ultimate net loss for any one occurrence while reinsurers are liable for losses in excess of $200,000 up to a limit of $1 million.

Premium revenue is reduced by premiums paid for reinsurance coverage of $2,951,635 and $855,204 in fiscal years 2001 and 2000, respectively.

NOTE J – CONTINGENCIES, UNCERTAINTIES AND SUBSEQUENT EVENTS

Subsequent to year–end, the Montana Board of Investments purchased Enron bonds of which $2,610,000 was allocated to MSF investment portfolio. The bonds have subsequently dropped to a market value that is significantly less than the purchase price.

NOTE K – RECLASSIFICATIONS

Certain classifications in the financial statements for the year ended June 30, 2000 have been changed to conform to current year classifications.

REPORT OF MANAGEMENT

The management of Montana State Fund (MSF) is responsible for the financial statements and all other information presented in this Annual Report. MSF maintains a system of internal control designed to provide reasonable assurance that assets are safeguarded against loss and that transactions are executed and recorded in accordance with management's authorization. This system encompasses the organizational structure, selection and training of personnel, communication and enforcement of policies and procedures, and ongoing internal and external audit programs. Internal controls are continually reviewed and evaluated by management.

The financial statements are presented for our fiscal year 2001 Annual Report and include amounts based on the best estimates and judgements of management. These financial results are presented on a statutory basis, which is consistent with insurance industry financial statement presentation. MSF governs, operates and completes its financial reporting as an insurance company domiciled in the State of Montana, and its financial statements are presented on the basis of accounting practices prescribed or permitted by the Montana Insurance Department.

Galusha, Higgins & Galusha, an independent public accounting firm, audited and issued an unqualified opinion on MSF's statutory financial statements presented in this Annual Report. The preparation and independent external audit of statutory financial statements is a discretionary act on the part of MSF, but one that is seen as important, as evaluating the financial status of MSF in relationship to other insurers aids in evaluating and maintaining the financial security of MSF as a workers' compensation insurer. In addition, MSF is a component unit of the State of Montana. As required in law the Legislative Audit Division (LAD) of the state of Montana conducts independent audits of financial statements of MSF presented in accordance with generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB). For the financial periods ending June 30, 2000 and 2001, the MSF received an unqualified audit opinion from LAD. The audited governmental financial statements and the related audit opinion are issued under separate cover. To obtain a copy of the full governmental financial statements, contact the Legislative Audit Division. The presentation of the statutory financial statements in this report differs from the governmental presentation basis (GASB). A financial reconciliation of surplus between the audited GASB financial statements and the audited statutory financial statements is presented below.

A comparison of GASB to Statutory Accounting Ending Surplus for the year ended June 30, 2001 (000's):

Governmental Accounting (GASB) Ending Surplus	$168,982
Reconciling Items:	
Unrealized Gain on Fixed Income Securities	(17,450)
Unrealized Loss on Equity Securities	(296)
Net effect of cumulative change in Non–Admitted Assets	(9,248)
Net Income Difference between Methods	8,892
Statutory Accounting Ending Surplus	$150,880

GALUSHA
HIGGINS &
GALUSHA

A Professional Corporation of
Certified Public Accountants and Advisors

111 N Last Chance Gulch, Helena, MT 59601
P.O. Box 1699, Helena, MT 59624

Phone (406) 442-5520
Fax (406) 443-1017

www.ghg-cpa.com

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

To the Board of Directors
Montana State Fund
Helena, Montana

We have audited the accompanying statement of admitted assets, liabilities and surplus (statutory basis) of Montana State Fund (New Fund), a component unit of the State of Montana, at June 30, 2001, and the related statements of operations, changes in surplus and cash flows (statutory basis) for the year then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note A, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of Montana, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the admitted assets, liabilities, and surplus (statutory basis) of Montana State Fund for the year ended June 30, 2001, and results of its operations, changes in surplus and cash flows (statutory basis) for the year ended June 30, 2001 on the basis of accounting described in Note A.

However, because the company prepares its financial statements on a statutory basis of accounting, as discussed in the preceding paragraph, it is our opinion, that the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of Montana State Fund for the year ended June 30, 2001 or the results of its operations, changes in surplus and cash flows for the year ended June 30, 2001.

The 2000 financial statements were compiled by us and our report thereon, dated November 19, 2000, stated we did not audit or review those financial statements and, accordingly, we express no opinion or any other form of assurance on them.

Galusha, Higgins & Galusha, PC

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

Helena, Montana
December 19, 2001

McGLADREY NETWORK
An Independently Owned Member
Worldwide Services Through RSM International

Billings · Bozeman · Havre · Helena · Missoula · Idaho Falls

GALUSHA
HIGGINS &
GALUSHA

A Professional Corporation of
Certified Public Accountants and Advisors

111 N Last Chance Gulch, Helena, MT 59601
P.O. Box 1699, Helena, MT 59624

Phone (406) 442-5520
Fax (406) 443-1017

www.ghg-cpa.com

January 25, 2002

Mr. Carl Swanson, President
Montana State Fund
5 South Last Chance Gulch
Helena, MT 59604

Dear Mr. Swanson:

Galusha, Higgins and Galusha, PC issued an audit report on the statutory financial statements of the Montana State Fund. The audit report covered the fiscal year ending June 30, 2001.

The audit report was without qualification, meaning the statutory financial statements present fairly, in all material respects, the admitted assets, liabilities and surplus of the company, as well as its results of operations and cash flows. The "unqualified" auditors report is the highest level of assurance provided by our profession. The statutory basis of accounting is premised on the Statements of Statutory Accounting Principles (SSAP) and is a specialized comprehensive basis of accounting developed by and for the insurance industry. We commend your organization for its dedication and diligence in preparing the statutory financial statements.

Our professional assurance reporting standards require the audit report to specifically state if the financial statements are prepared in accordance with generally accepted accounting principles (GAAP). GAAP is the most common basis of presentation used by the accounting profession and it is designed to meet the varying needs of the different users of financial statements. As a result, GAAP stresses measurement of emerging earnings of a business from period to period, while SSAP stresses measurement of ability to pay claims in the future. One transaction may result in significantly different financial statement results depending on which basis of accounting is used.

If financial statements use a basis of presentation other than GAAP, the audit report is required to say that the financial statements do not present fairly in accordance with GAAP. This statement does not diminish the quality of the SSAP financial statements. It is meant to remind the user of financial statements that there are differences in the two accounting presentations and to clearly indicate which basis of accounting was used to prepare the financial statements presented.

Sincerely,

Galusha, Higgins & Galusha, PC

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

McGLADREY NETWORK
An Independently Owned Member
Worldwide Services Through RSM International

Billings · Bozeman · Havre · Helena · Missoula · Idaho Falls

One Atlanta Plaza
950 East Paces Ferry Road
Atlanta, GA 30326-1119
404 365-1600
Financial Services Fax: 404 365-1197
Property/Casualty Fax: 404 365-1663

Tillinghast - Towers Perrin

January 21, 2002

To The Board of Directors of the Montana State Fund:

Tillinghast – Towers Perrin was engaged by the Montana State Fund (MSF) to estimate the unpaid loss and loss adjustment expenses as of June 30, 2001, for MSF's workers compensation exposures. Our examination included the performance of independent projections of MSF's loss and loss expense liabilities and such other tests and procedures as we considered necessary in the circumstances. We relied on MSF personnel as to the completeness and accuracy of the data.

Our estimated loss and loss adjustment expense liability as of June 30, 2001, is $323.9 million, undiscounted, and net of reinsurance recoverables. MSF has recorded a provision of $325.9 million on its June 30, 2001 balance sheet for unpaid loss and loss adjustment expense.

In our opinion, the amounts recorded in the balance sheet as reserves for estimated loss and loss adjustment expense liabilities: (1) Are consistent with amounts calculated in accordance with commonly accepted actuarial methods and are fairly stated on an ultimate undiscounted basis in accordance with sound actuarial principles; (2) Are consistent with amounts based upon actuarial assumptions which are reasonable given the coverages provided; and (3) Make good and sufficient provision in the aggregate for all unpaid loss and loss adjustment expense obligations.

The Policyholders' Surplus of MSF as of June 30, 2001, is $150.9 million, using statutory accounting principles. Current year premium revenue was $74.5 million. We note that the Policyholders' Surplus level of MSF is consistent with traditional industry standards. We believe that it is prudent for MSF to set a long-term goal of maintaining appropriate surplus based on industry standards.

VARIABILITY

Loss and loss adjustment expense reserve estimates are subject to considerable uncertainty due to the fact that the ultimate liability for claims is subject to the outcome of events yet to occur. In evaluating whether the reserves make a reasonable provision for unpaid losses and loss expenses, it is necessary to project future loss and loss adjustment expense payments. Actual future losses and loss adjustment expenses will not develop exactly as projected and may, in fact, vary significantly from the projections.

Robert F. Conger
Fellow, Casualty Actuarial Society
Member, American Academy of Actuaries

BOARD OF DIRECTORS

(left to right/back row)

TOM HORN
Cohagen Ranching

ROBERT COPE
President
Western Energy

DEREK GREWATZ
Vice President and
Chief Marketing Officer
Western States Insurance

CARL SWANSON
President/CEO
Ex-Officio

HERBERT LEUPRECHT
Chairman, Butte
Business Owner

(left to right/front row)

WENDY SUSOTT
Missoula Banking Industry

LORETTA LYNDE
Helena Management
Consulting

(not pictured)
SUSAN KNEPLER
General Manager
Hi-Heat Industries, Inc.

EXECUTIVE TEAM

(left to right)

NANCY BUTLER
General Counsel

LAURENCE HUBBARD
Vice President Insurance
Companies

LINDA GOAN
Special Assistant to the
President

MARK BARRY
Vice President Corporate
Support

JILL LOTTER
Vice President Insurance
Operations Support

ANNUAL REPORT 2001

5 South Last Chance Gulch | P.O. Box 4759 | Helena, MT 59604-4759
800-332-6102 | 406-444-6500 | 406-444-7796 Fax
www.montanastatefund.com